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In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 1138

RICHARD H. DUNNING AND BEULAH MARIE DUNNING,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioners, shareholders of the Missouri Public Service Company (New Missouri), claim that a portion of the cash distributions they received from that corporation in 1958, 1959, and 1960 exceeded current and accumulated earnings and profits and to that extent constituted a return of capital. Resolution of this question depends on whether New Missouri, which was reorganized in a proceeding under Section 77B of the Bankruptcy Act[1] on December 1, 1936, is

[1] Bankruptcy Act, c. 541, 30 Stat. 544, Section 77B, as added by the Act of June 7, 1934, c. 424, 48 Stat. 911, Section 1.

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entitled to carry over the pre-reorganization deficit of its predecessor (Old Missouri) to offset its own post-reorganization earnings and profits (Pet. App. 27–28). All parties agree that unless the deficit is carried over, New Missouri had sufficient accumulated earnings to make each of the 1958–60 distributions fully taxable as a dividend (Pet. App. 30).

In the 1936 reorganization, it was determined that the value of Old Missouri's assets was not sufficient to entitle the common stockholders to any direct interest in the reorganized company, and thus under the plan of reorganization the bondholders and preferred stockholders received all the common stock of New Missouri.[2] Since Old Missouri's sole common stockholder (Middle West Public Utilities Corporation) held a substantial amount of that corporation's bonds, it received, qua bondholder, approximately 30 percent of New Missouri's common stock. Old Missouri's preferred stockholders received approximately 22 percent of New Missouri's capital stock. Thus, Old Missouri's former equity holders owned approximately 52 percent of New Missouri's capital stock (Pet. 5; Pet. App. 30–31).

[2] Technically, the common stock was exchanged for warrants entitling the holder to purchase an aggregate of 13,000 shares of New Missouri's common stock. However the warrants had no fair market value when issued or at any time thereafter and none was ever exercised. In their opening brief in the court of appeals, petitioners admitted that the common stockholder was (Br. 55) "wiped out" and the court of appeals agreed that the issuance of the warrants did not reflect any residual equity on the part of the common stockholder and was not of substantive significance in disposing of the issues presented (Pet. App. 30–31).

On these facts both of the lower courts held that Old Missouri's pre-reorganization deficit did not survive the reorganization and could not be used to offset New Missouri's post-reorganization accumulated earnings.

The decision below is correct, and the allegedly contrary decision of the Court of Appeals for the Tenth Circuit in *United States* v. *El Pomar,* 330 F. 2d 872, is distinguishable on its facts.

1. Any distribution made by a corporation to its shareholders out of either current earnings and profits or earnings and profits accumulated since 1913 constitutes a dividend. Int. Rev. Code of 1954, § 316. Distributions in excess of earnings and profits constitute a return of capital. § 301(c). Congress selected accumulated earnings to serve as the yardstick in order to distinguish distributions that represent a return *of* original invested capital from those corporate distributions that represent a return *on* original invested capital (*i.e.,* a dividend). Thus, the existence of an earnings deficit indicates that corporate losses have impaired the original contributed capital to the extent of the deficit and any distributions to stockholders would constitute a further impairment, *i.e.,* a return of capital.

When, as in this case, it has been determined in a bankruptcy proceeding that operating losses (which are reflected in the deficit) plus declines in the market value of the corporate assets (which are not taken into account in computing earnings and profits) have completely extinguished the common stockholder's in-

vestment, elimination of the stockholder from participation in the reorganized corporation, qua stockholder, should also eliminate the deficit. After the bankruptcy reorganization, the common stockholder was entitled to recognize its loss on its common stock investment (through a worthless stock deduction—see 1954 Code, § 165(g)). Since the corporate losses which created the deficit and (along with the market value decline) caused the elimination of the common stockholder's interest were recognized by the eliminated stockholder at the time of the original insolvency proceedings, the deficit should also be closed out. See *McCullough* v. *United States,* 344 F. 2d 383 (Ct. Cl.), certiorari denied, 382 U.S. 901. In other words, since the effect of the 1936 reorganization was to wipe out the capital contribution of the old common stockholders and to substitute therefor the capital contributed by the new common stockholders through the conversion of their debt and preferred stock into common stock, dividends paid on the latter out of earnings since 1936 do not constitute a return of capital.

It would make no sense to permit the deficit to be carried over to New Missouri. The amount of Old Missouri's deficit bore no relation to the new stockholders' (former bondholders and preferred stockholders) investment in Old Missouri. For example, assume that Old Missouri's original common stockholder invested $1,000,000 and that bondholders and preferred stockholders invested an additional $500,000, that the corporation lost $1,000,000 and then went

through a bankruptcy reorganization with the bondholders and preferred stockholders receiving all the new corporation's common stock. The deficit of $1,000,000 would have no relationship to the capital invested by the new stockholders ($500,000), or to their unrecognized gain or loss on the exchange of their bonds and preferred stock for common stock. However, if the deficit were carried over, the new corporation could earn $1,000,000 and in a later year distribute that amount as a "return of capital" to a group whose total investment was only $500,000 and whose entire investment is still intact.

The incongruity of carrying over the deficit is not diminished where, as here, the sole common stockholder of the old corporation also owned some of the new corporation's outstanding bonds and received a stock interest in the new corporation in exchange for its bonds. Elimination of its interest in the Corporation qua stockholder would still give rise to a $1,000,000 worthless stock deduction.[3]

Thus, both courts below correctly held that the bankruptcy reorganization eliminated Old Missouri's deficit and that there was thus no deficit to carry forward to New Missouri. Any other conclusion would have resulted in a competely unjustified tax

[3] Assuming *arguendo*, as did the court of appeals below (Pet. App. A 29), that the bankruptcy reorganization constituted a tax-free corporate reorganization under § 112 of the Revenue Act of 1936, c. 690, 49 Stat. 1678, the common stockholder's receipt of warrants would not constitute stock or securities subject to § 112's non-recognition provisions and the common stockholder was required to recognize its loss in 1936. See *Helvering* v. *Southwest Corporation*, 315 U.S. 194.

benefit akin to a double deduction (once to the old stockholder as a worthless stock deduction and again for the benefit of the new stockholders in eliminating the new corporation's taxable earnings).[4]

2. Petitioners allege that there is an "irreconcilable conflict" (Pet. 9) between the instant decision and the decisions in *United States* v. *Snider*, 224 F. 2d 165 (C.A. 1), and *United States* v. *El Pomar Investment Co.*, 330 F. 2d 872 (C.A. 10). *Snider* is completely distinguishable from the instant case. It involved a Massachusetts real estate trust (taxable as a corporation) operating two unsuccessful hotels which was reorganized into a parent and subsidiary corporation. No bankruptcy proceeding was involved and there was no material change in shareholders, assets, liabilities or business operations. Accordingly, the court held that the deficit of the trust carried over to the parent corporation.

El Pomar involved a bondholder's purchase of the assets of an unsuccessful corporation at a foreclosure sale in 1920. The assets were transferred to a new corporation in which the bondholders received new bonds and common stock. In 1930, a second foreclosure sale occurred and the assets were transferred to a third corporation. As a result of the first reorganization, all

[4] This result is also in accord with standard accounting practice. See, *e.g.*, Paton and Dixon, *Essentials of Accounting* (1958 ed.), pp. 645–649. Accordingly, no entry was made on the books of the reorganized company to reflect the claimed deficit (Pet. App. 32–33).

of the shareholders of the second corporation also owned bonds of that corporation and consequently, as in the instant case, the shareholders of the second corporation received (qua bondholders) the stock of the third corporation. Although the court declined to pass on whether or not a deficit carried over through the first foreclosure sale (330 F. 2d at 885), it held that the deficit of the second corporation was available to offset the earnings of the third corporation. If the Tenth Circuit's decision stands for the proposition that the deficit carried over because, even though the stockholders did not participate in the reorganization as stockholders, they were also bondholders and therefore were entitled to receive stock in the third corporation in exchange for their bonds, we would agree that there is a conflict in principle between the instant case and *El Pomar*.

However, the court in *El Pomar* several times suggested that it was basing its decision on the ground that the voluntary insolvency proceeding there in question did not reflect the substance of the transaction and that the common stockholders might actually have been entitled to a continuing interest in the third corporation *with respect to their stock* (rather than because they also owned bonds).[5] If

[5] Early in its opinion the court stated (330 F. 2d at 876):

> While technically the foreclosure on each reorganization wiped out the interests of unsecured creditors and stockholders of the respective predecessor corporation, that result did not actually occur as the reorganization was

this were indeed the substance of the transaction, the common stockholders would not have been entitled to a worthless stock deduction and would have been required to carry over the basis of both their stock and bonds in the second corporation as the basis of the stock they received in the third corporation. In such circumstances, *El Pomar* would not only be completely distinguishable from the instant case, but it would also be correct. Accordingly, while on the basis of the *El Pomar* opinion it is unclear whether the Tenth Circuit would have reached the same results as the court below on the facts of the instant case, it appears that the decision of the Tenth Circuit turned primarily upon its interpretation of the transaction before it rather than the application of different legal principles from those applied in the present case.[6]

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carried out. On each reorganization the successor corporation assumed and paid in full the indebtedness of the unsecured creditors, * * * and on the second reorganization all of the holders of stock in the predecessor corporation received stock in the successor corporation, thus preserving a continuity of stock ownership and the adjustment of the bond indebtedness * * * enhanced the value of the stockholders' equity.

A little later in the opinion the court suggested that the end result of the transaction before it was no different than if, instead of undergoing a reorganization, the corporation had simply issued additional common stock to its bondholders without extinguishing their interest as shareholders (330 F. 2d at 883–884). Finally, the court noted that "Here, only secured indebtedness of the bondholders was adjusted. Such adjustments increased the stockholders' equity" (330 F. 2d at 884).

[6] With the possible exception of *El Pomar*, every court that has considered the effect of a bankruptcy reorganization in which the stockholders were eliminated has concluded that a

For these reasons, the petition for a writ of certiorari should be denied.[7]

Respectfully submitted,

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MAY, 1966.

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pre-bankruptcy deficit may not be carried forward to offset post-bankruptcy accumulated earnings. *United States* v. *Kavanagh*, 308 F. 2d 824 (C.A. 8); *Banister* v. *United States*, 236 F. Supp. 972 (E.D. Mo.), appeal to C.A. 8 dismissed; *McCullough* v. *United States*, 344 F. 2d 383 (Ct. Cl.), certiorari denied, 382 U.S. 901; *Caspers* v. *Commissioner*, 44 T.C. 411. Indeed, where the stockholders have been eliminated, even a surplus in earnings is not carried forward. *Humpage* v. *Commissioner*, 17 T.C. 1625, acquiescence, 1962–2 Cum. Bull. 4.

[7] All courts would agree that if the transfer of assets from Old Missouri to New Missouri did not qualify as a tax-free reorganization under § 112 of the Revenue Act of 1936 (which was in force at the time of the instant transfer) there could be no basis for carrying over either a deficit or surplus from one corporation to another. Here, the district court held (Pet. App. 3–26) that the 1936 bankruptcy reorganization was not tax-free, but the court of appeals found it unnecessary to reach this question, holding that the deficit would not carry over even assuming *arguendo* that the 1936 transfer did constitute a non-taxable reorganization. If certiorari should be granted in the instant case and if the decision of the court of appeals should ultimately be reversed, the case should be remanded to permit the court of appeals to consider this alternative argument.

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